

AFTER LANGUISHING FOR MOST OF THE YEAR DESPITE STRONG PROFIT GROWTH AND OTHER SIGNS OF ECONOMIC FIRMING, *the stock market finally rose in a post-election rally. Large cap stocks did well, but for the sixth consecutive year, small and midcap stocks were the best performers. In the fixed income market, Treasury bond levels remained stable despite five tightenings of monetary policy by the Federal Reserve Board. In a market starved for yield, corporate and high yield bonds performed particularly well. As 2005 begins, no asset class appears undervalued and performance may hinge on such factors as the dollar's strength or weakness.*



The PERAC Financial Bulletin

Financial Market Review, 4th Quarter 2004

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Public Employee Retirement Administration Commission

Five Middlesex Avenue, Third Floor | Somerville, MA 02145

Phone 617 666 4446 Fax 617 628 4002

TTY 617 591 8917 Web www.mass.gov/perac

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The year 2004 saw solid but unspectacular returns from the financial markets. Thanks to a strong fourth quarter, the stock market posted back-to-back gains for the first time since 1999. Despite Fed tightening of monetary policy, bonds enjoyed their fifth consecutive year of positive returns. While the best performing investment in 2004 would have been crude oil, whose price rose over 34%, the only sure way to lose money would have been to bet on the US dollar, whose trade-weighted value declined over 5%.

THE EQUITY MARKET

With the presidential election decisively resolved and the economy showing signs of strength amid stabilized oil prices, the stock market rallied in November, temporarily ignoring the unsettled situation in Iraq and the lingering threat of terrorism. Major US stock indexes rose 9–14% during the fourth quarter, leading to returns of 11–18% for the year. (*See accompanying table.*) The Dow Jones Wilshire 5000, the broadest measure of the market, rose 10.3% for the quarter and 12.6% for the year.

Despite many predictions that their run would be over, small cap stocks—by a significant margin—outperformed large caps for the sixth consecutive year. The Russell 2000 ended 2004 at an all-time high, while the S&P 500 still needs a 26% rally to recapture its previous high reached in March 2000 (although more than

half the stocks within the index have already exceeded their previous highs). Midcaps also outpaced the S&P 500. Over the past five years, small caps (Russell 2000) have outperformed large caps (S&P 500) by an annualized 8.9%. The NASDAQ Composite, after rising 50% in 2003, cooled off in 2004, up only 8.6%. Some technology stocks, notably Intel, actually declined. The NASDAQ remains well below half its 2000 high.

Performance in 2004 was defined not as much by sectors as by the fortunes of individual companies. Several of the most prominent stocks in the large cap universe suffered particularly bad years in 2004, including Merck (-27.8%), Intel (-26.9%), Pfizer (-22.3%), General Motors (-21.4%), and Coca Cola (-16.2%). Others, such as McDonalds (+31.56%), Exxon Mobil (+28.1%), Johnson & Johnson (+25.2%), Boeing (+24.9%), Home Depot (+21.5%), and General Electric (+20.7%) outpaced the general market. Overall, however, since the largest of the large caps underperformed the index as a whole, investors would have done better investing in the S&P 500 on an equal-weighted basis rather than the capitalization-weighted basis on which it is conventionally calculated.

Also continuing a long-run trend, value outperformed growth in 2004, with the margins largest in the small cap and midcap universes. Over the past five years, value has outperformed growth by an annualized 9.5% among large caps (S&P 500/Barra) and by almost 21% among small caps (Russell 2000).

Economic growth overseas generally mirrored that of the US, but US investors enjoyed strong returns from overseas markets as a result of the declining dollar. As our current account deficit rose to 5.6% of GDP, the dollar sunk to 5-year lows against the Euro and the yen and to 12 and

13-year lows against the British pound and the Canadian dollar, respectively. The total return of the MSCI-EAFE Index, up 6.8% for the quarter and 12.7% for the year in local currency terms, was up 15.3% and 20.2%, respectively, in US dollar terms. Oil producing countries such as Mexico and Venezuela did particularly well, and some Asia Pacific nations such as Australia, Singapore, and Hong Kong enjoyed impressive economic growth.

THE BOND MARKET

Beginning in June, the Federal Reserve Board raised the federal funds rate five times from 1% to 2.25%. However, confounding conventional wisdom, rates on long bonds did not rise in concert. Rates on 2-year Treasury notes rose from 1.84% to 3.07% over the year but yields on the 10-year Treasury bond, which began the year at 4.26%, rose to 4.90% in June and fell below 4% in October, actually ended the year lower at 4.22%. Thus, the main effect of the Fed's actions has been a flattening of the yield curve.

The steadiness of the bond market in the face of Fed tightening reflects the fact that inflation, at around 3%, remains low and that the Fed has been basically moving to normalize short rates from their extraordinarily low levels of recent years. In addition, there was the significant purchasing of US Treasuries by foreign governments who hoped to protect their exporting industries by preventing a free-fall of the dollar.

With the federal funds rate still below the inflation rate, further Fed tightening is anticipated in 2005, especially if the job market shows marked improvement.

As in the stock market, the traditionally riskier segments of the fixed income market did the best in 2004. Corporate bonds outpaced Treasuries as economic growth nor-

Chart 1

2004: Stagnation, Then a Late-Year Rally



Chart 2

S&P 500: Five Year Perspective



Chart 3

S&P 500: Ten Year History



Chart 4

S&P 500 vs. NASDAQ: Except for the Bubble Years, Pretty Close



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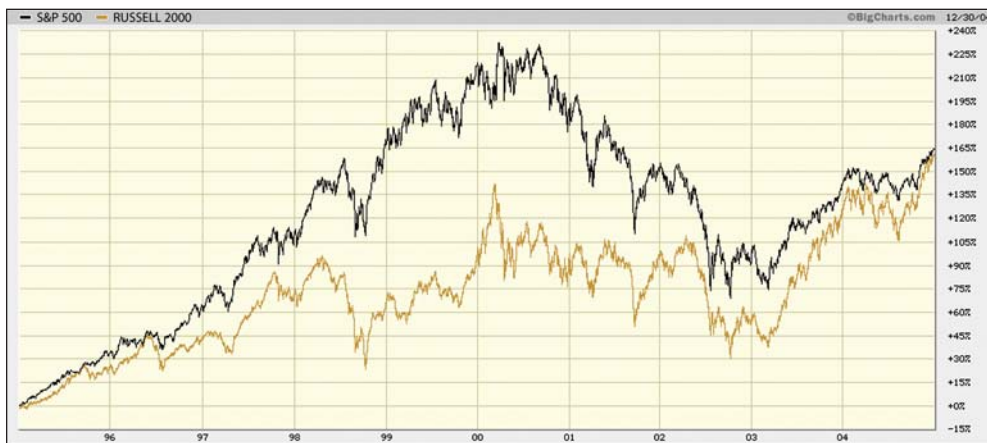


Chart 5

Large Cap vs. Small Cap: Over Ten Years, About Even

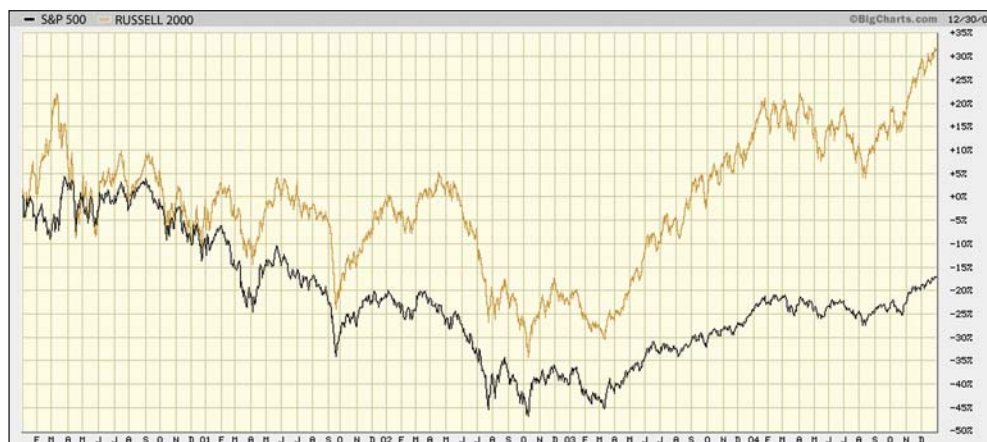


Chart 6

S&P 500 vs. Russell 2000, Five Years: Small Caps Rule

malized and investors were hungry for incremental yield. At year-end, quality yield spreads were generally the narrowest since 1998. High yield “junk bonds” posted double digit returns again as their yield advantage over high grade bonds decreased to historically narrow margins.

OTHER ASSET CLASSES

Real estate continued to perform well. Publicly-traded REITs, supported by improving real estate fundamentals, a tepid stock market for most of the year, and attractive dividend yields relative to stocks, had another spectacular year, up over 30%. Returns were also improving on privately held real estate, with the most recent quarterly returns indicating annual gains in excess of 12%, with retail space being the hottest sector.

Returns are lagged by more than a quarter, but performance of venture capital and other segments of private

equity continued to improve in 2004. It was the best year since 2000 for initial public offerings, although after-market performance of most IPOs was unspectacular. IPO activity by venture-backed companies in 2004 exceeded the prior three years combined in terms of the value of offerings.

For hedge funds, 2004 was disappointing to those who expected greater overall returns from this asset class. Nevertheless, it was also disappointing to those cynics who have predicted a rash of blow-ups or other form of meltdown for the rapidly growing hedge fund industry. Assets under management are estimated to be approaching \$1 trillion (although that is still only about one eighth the size of the mutual funds industry) and more large public pension funds have initiated hedge fund investments. Constrained by lackluster markets, low volatility, and, in some cases, too much hedge fund

money chasing the same opportunities, composite returns on all hedge fund strategies approximated that of the S&P 500 through the end of November. In December, the SEC finalized its rules for regulation of hedge funds. There was much debate within the industry about the likely effect and ramifications of these regulations, which are due to take effect in February 2006. (Retirement boards interested in reading PERAC’s overview of hedge funds should contact Investment Director Robert Dennis.)

OUTLOOK

Two thousand and four was a year in which most public funds came close to or exceeded their target rates of return, but, once again, the future is clouded as no asset class appears to offer attractive value. Stocks are fully priced relative to earnings by historic standards, last year’s 20% rate of profit growth is expected to decline

substantially, and the market is approaching the typical duration (about two and a half years) of a cyclical bull market. For fixed income investors, if the economy continues to improve and inflationary expectations begin to rise, the prospect of higher interest rates means lower bond prices for current investors as well as a further challenge to the valuation of equities. Furthermore, the world is fraught with geopolitical and economic uncertainty and risk. In assessing both the gains of the past year and the challenges ahead, boards are reminded of the importance of maintaining asset allocation that is as balanced and as well diversified as possible and in ensuring that all investment managers are carefully monitored, with no tolerance of managers who consistently under-perform their benchmark or who otherwise fail to fulfill their mandates.

As always, the PERAC Investment Unit welcomes the opportunity to work with retirement boards and to provide assistance in any phase of their investment program.

Chart 7. Interest Rates: Low, but Heading Higher?



Chart 8. The Yield Curve Has Flattened Significantly

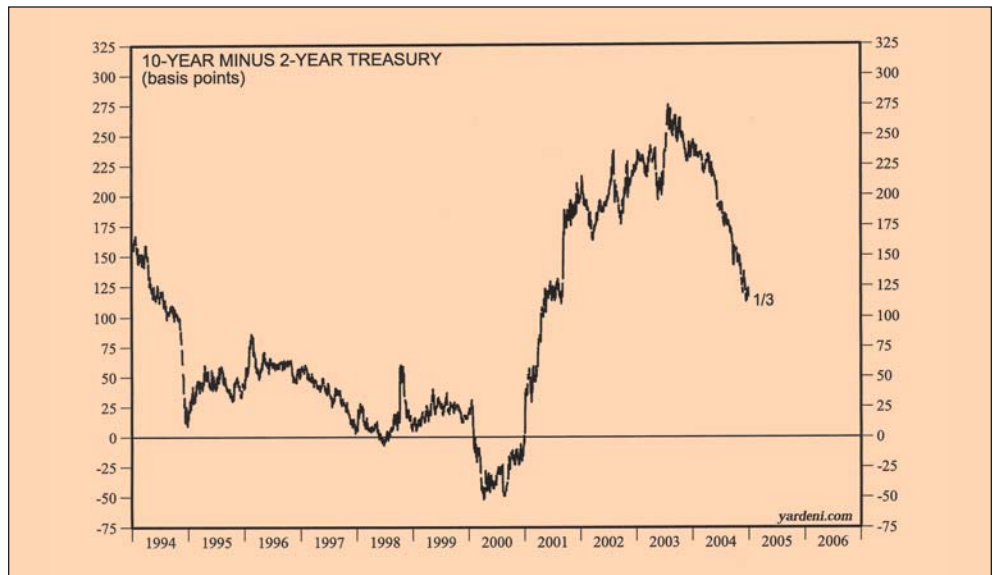
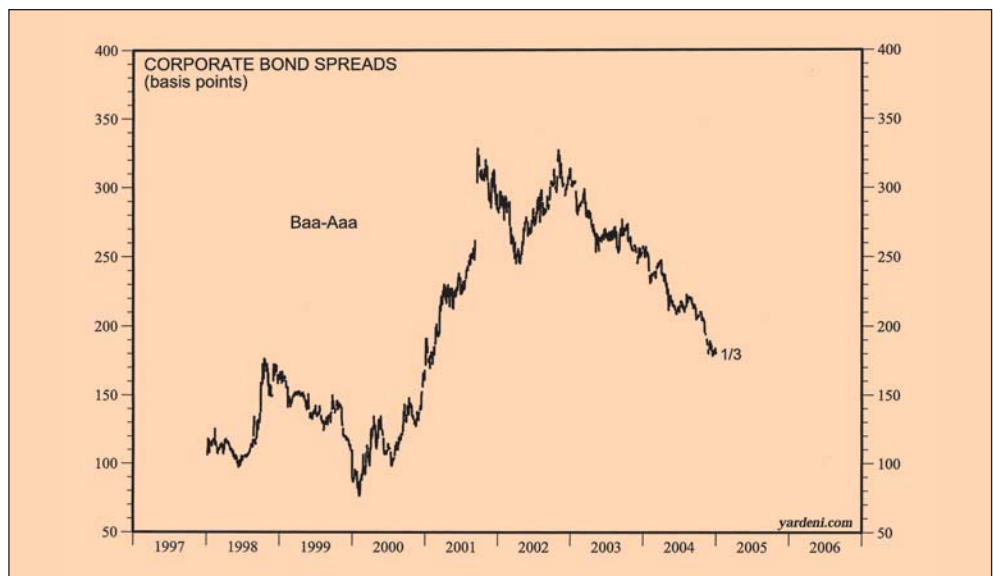


Chart 9. The Yield Advantage of Lower Quality Bonds Has Narrowed Significantly



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TOTAL RETURNS | *4th Quarter, 2004*

INDEX	FOURTH QUARTER, 2004	TWELVE MONTHS, 2004
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 7.59%	+ 5.31%
Standard & Poor's 500 (Large Cap)	+ 9.23%	+ 10.88%
NASDAQ Composite	+ 14.69%	+ 8.59%
Wilshire 5000 (Broad Market)	+ 10.33%	+ 12.62%
Standard & Poor's Mid-Cap 400	+ 12.16%	+ 16.48%
Russell 2000 (Small Cap.)	+ 14.09%	+ 18.33%
GROWTH VS. VALUE		
S&P 500 Growth	+ 8.51%	+ 6.13%
S&P 500 Value	+ 9.93%	+ 15.71%
S&P Midcap 400 Growth	+ 12.05%	+ 14.00%
S&P Midcap 400 Value	+ 12.25%	+ 18.93%
Russell 2000 Growth	+ 15.08%	+ 14.31%
Russell 2000 Value	+ 13.20%	+ 22.25%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 15.32%	+ 20.25%
M.S.C.I. - Emerging Markets	+ 17.24%	+ 25.55%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 0.95%	+ 4.34%
Merrill Lynch High Yield Index	+ 4.46%	+ 10.76%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 15.23%	+ 31.58%
NCREIF Property Index	+ 3.42% (Q3)	+ 11.24% (Trailing 12 months)

